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# In the Supreme Court of the United States

OCTOBER TERM, 1942

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No. 33.

RECONSTRUCTION FINANCE CORPORATION, PETITIONER

v.

WESTERN PACIFIC RAILROAD CORPORATION ET AL.

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BRIEF FOR INTERSTATE COMMERCE COMMISSION  
AS AMICUS CURIAE

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## PRELIMINARY STATEMENT

The Interstate Commerce Commission, charged with primary responsibility in the administration of railroad reorganization proceedings, respectfully submits this brief as *amicus curiae* in the *Western Pacific* cases. To avoid unnecessary repetition the Commission refers the Court to the statements of fact as they appear in the briefs of the Reconstruction Finance Corporation (No. 33) and of the Institutional Bondholders Committee (No. 7). Several of the points of argument which the Commission would desire to urge upon the Court have likewise been adequately presented in

*extenso* by these briefs. The argument here will be confined to discussion of the case under the following headings:

- I. The decision of the court below and the position of the Commission with respect thereto.
- II. Precise dollar and cents findings of value would be fictitious and misleading.
- III. Compliance with the decision of the court below will involve administrative difficulties tending to defeat the objectives of Section 77.
- IV. The court below misapplied the *Consolidated Rock Products* decision.

#### ARGUMENT

##### I

The disputes which gave rise to the appeals from the action of the District Court in approving a plan of reorganization concerned the relative treatment of the stockholders and junior creditors of the debtor. There was no challenge to the new security structure in its provision for \$10,000,000 first mortgage fixed income bonds or in their allocation to the payment of the trustees' certificates. The same was true in respect of permitting the equipment trusts to remain undisturbed. The exclusion of stockholders and unsecured creditors and the allotment of income mortgage bonds and the new stocks were the only substantial points

upon which the Circuit Court of Appeals was asked to pass.

That court declined to approve the plan because, as it asserted, the Commission had failed in its duty under the Act of making determinations of value upon which the District Court could independently determine subordinate factual matters on which to predicate an ultimate finding that the plan "is fair and equitable, affords due recognition to the rights of each class of creditors and stockholders, does not discriminate unfairly in favor of any class of creditors or stockholders, and will conform to the requirements of the law of the land regarding the participation of the various classes of creditors and stockholders." In so doing, the court relied upon that portion of subparagraph (e) of Section 77 providing that "If it shall be necessary to determine the value of any property for any purpose under this section, the Commission shall determine such value and certify the same to the court in its report on the plan." The essence of the court's decision is that where any class of claimants is to be excluded from participation and where senior and junior creditors are involved, the necessity for precise valuation is also present.

The court strongly intimates that the record before the Commission was deficient in "requisite valuation data." If this is the holding of the lower court, it becomes pertinent to determine

what elements of value are to be considered in reorganization proceedings, first, as a basis for denying participation to any class of stockholders or creditors, and, secondly, as a basis for determining whether senior claimants have received full compensatory treatment before distribution is made to junior claimants.

The Commission's position in this case is that the Circuit Court of Appeals has placed a too restrictive interpretation upon Section 77 with respect to the Commission's part in the reorganization proceedings. It has failed to give recognition to the administrative function of the Commission. It has failed to give effect to the object sought in the 1935 amendment to Section 77, and in so doing, has needlessly created an impractical procedure entailing great delay and heavy expense both to the parties and the railroad estate. If the court's opinion means that the Commission must undertake a valuation of the whole estate of the debtor and of the several parts that may be the subject of the lien of different mortgages, using the same principles that are applicable in Section 19 (a) valuations, the effectiveness of reorganization proceedings has been destroyed.

Under the original provisions of Section 77, as enacted in 1933, no reorganizations were consummated. It was early found that the requirement that an elimination of the consent of a claimant



must be conditioned by a determination by the court that its interest was without value,<sup>1</sup> would lead to long delays and unwarranted expense by requiring the introduction of testimony on valuation of property and its segments applicable under section 19a in the determination of rate-making value. This, the Commission considered, was not a true test of value in the reorganization sense; rate-making value arrived at by conven-

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<sup>1</sup> 48th Annual Report of the Interstate Commerce Commission, 1934, pp. 18, 19:

It has become quite evident that the advantages hoped for in the enactment of section 77 of the Bankruptcy Act are not likely to be realized without substantial changes in its provisions. \* \* \*

"Proceedings under section 77 could be further facilitated by a legislative definition of insolvency, as applied to operating railroads, and the designation of an agency and procedure whereby the fact of insolvency may be uniformly, speedily, and economically determined. \* \* \* Further, the acceptance of a proposed plan of consolidation by the stockholders of a railroad corporation is not necessary where the court shall have determined that the corporation is insolvent; and an approved plan of reorganization is binding upon stockholders where a finding of insolvency has been made. The Supreme Court has provided in its rules that upon our application, prior to our approval of a plan of reorganization, the court, after a hearing, shall determine whether or not a corporation is insolvent. Apparently, the courts are regarded as the only present authority for the determination of this question. Considering that reorganizations will take place in many different jurisdictions, there is ground for the belief that better results might be obtained by the designation of a common agency for the performance of this duty."



tional means is not a true measure of value for reorganization purposes.<sup>2</sup>

In arriving at its findings in the case and in its consideration of the factors upon which they were based, the Commission deemed that it was following the prescription of the statute and the legislative intent as expressed by the 1935 amendment. It considered that the public interest in the preservation of the railroad as an operating concern and its ability to continue in that capacity was of equal importance to the private rights of existing creditors and stockholders. Its endeavors have been pointed to that objective, while at the same time it has sought to preserve the relative priorities of the several classes of claimants in their participation in the reorganized company. In applying the legislative mandate of the valuation provisions of subparagraph (e), it did not read in them a duty to make exact findings of value in order to reach findings of want of equity or to determine exactly in dollars the respective equities of the several classes of claimants. The Commission realized that at best it could only reach an approximation of value and that its findings would still be an approximation in fact, although clothed in terms of dollars and cents findings. It construed the provisions as a delegation of a duty to use its best judgment in arriving at a fair and

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<sup>2</sup> See testimony of Mr. Craven in Hearing before the Committee on Judiciary on H. R. 6249, 74th Cong., 1st Sess. (1935), pp. 23 *et seq.*

equitable plan of reorganization based upon valuations that were the closest estimation of the commercial worth of the property securing liens, having in mind the necessity of giving principal weight to earning power. Observance of the rule of absolute priority was a consideration which had to be fitted into the legislative scheme of reorganization. This entailed a determination of what allotment of new securities would satisfy the rule. It was clear that the value of the property as a whole was not to be measured by liquidation value or realizable yield upon forced sale. When such value had to be translated into terms of allowable capitalization, economic principles as well as the legislative direction dictated that earning power be given great weight. But it was also recognized that other elements might have to be given consideration. So, too, in evaluating the component parts of a property in order to apply the rule of absolute priority, the value of the isolated item—which would be the limit of the security of the lien should it be reduced to cash—was not a true test since each item of property derived additional value by reason of its relation to the whole property as an operating unit. Faced with these conditions, the Commission has consistently determined the allowable capitalization, the kind and character of the new securities making up the total and the allocation of the new securities to the various classes of claimants upon a finding

that "the securities represent the equitable equivalent of the debtor's assets available for satisfaction of claims" and has made its allotment upon its finding "as to the relative priority, value, and equity of the various claims and the value of the new securities available in exchange therefor." This method of treatment the Commission considers to be sufficient under Section 77 and to comply fully with the rule of absolute priority and the principles enunciated by this Court in *Case v. Los Angeles Lumber Co.*, 308 U. S. 106, and *Consolidated Rock Products Co. v. DuBois*, 312 U. S. 510.

## II

The fairness and equitableness of a plan of reorganization does not depend upon findings of absolute values even assuming they could be ascertained. That would be to assume a simplicity which does not and cannot exist. The formulation of a fair and equitable plan is not a mere matter of a mathematical calculation. This Court has repeatedly recognized that value is a judgment figure. Even where it is necessary to adopt a dollar value as a practical necessity, as in rate-making or taxation, this Court has recognized that the value so reached is more or less fictitious. Thus in *The Minnesota Rate Cases*, 230 U. S. 352, 434, it was said:

The ascertainment of that [rate-making] value is not controlled by artificial rules. It is not a matter of formulas, but there

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must be a reasonable judgment having its basis in a proper consideration of all relevant facts. \* \* \*

Mr. Justice Brandeis, dissenting in *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U. S. 276, 292, said:

It is impossible to find an exchange value for a utility, since utilities, unlike merchandise or land, are not commonly bought and sold in the market. \* \* \*

Again speaking of value of a railroad for tax purposes this Court in *Rowley v. Chicago & N. W. Ry.*, 293 U. S. 102, 109-110, said:

The ascertainment of the value of a railway system is not a matter of arithmetical calculation and is not governed by any fixed and definite rule. Facts of great variety and number, estimates that are exact and those that are approximations, forecasts based on probabilities and contingencies have bearing and properly may be taken into account to guide judgment in determining what is the money equivalent—the actual value—of the property. \* \* \*

The determination is to be made in the exercise of a reasonable judgment based on facts so pertinent and significant as to be of controlling weight as indications of the value of the property.

In *Nashville, C. & St. L. Ry. v. Browning*, 310 U. S. 362, 370, which dealt with a tax assessment, this Court said:

\* \* \* railroads, unlike farms and city lots and stocks and bonds, are not objects of exchange. The very notion of a "full cash value" for a railroad is in many respects artificial. See 1 Bonbright, The Valuation of Property, pp. 511-632. Whatever may be the pretenses of exactitude in determining such a "value," to claim for it "scientific" validity, is to employ the term in its loosest sense. \* \* \*

In railroad reorganizations the same obstacle to true findings of dollar value obtains. The exchange is not one of property or securities for cash, but of new securities for old securities or claims. A fair exchange is all that the law requires. And whether it is a fair exchange must be based upon the exercise of an informed judgment. If dollar value could be matched against dollar value there would be no need for an expert body. So if certainty cannot be attained the use of terms of certainty is illusive. But here the practical necessity does not exist. The rule of full compensatory provision should be applied realistically, and if the Commission's allocation of new securities—representing as it does its best judgment as to comparative values of both the new securities and the old securities to be surrendered—is supported by reasoned analysis of the evidence the plan should not be condemned simply because the Commission has not arbitrarily stated that the exact dollar values of the securities to be exchanged are absolutely equal.



With respect to making a precise finding of value of parts of the system the Commission recently has said in *St. Louis-S. W. Ry. Reorganization*, 252 I. C. C. 325, 361:

The properties comprise one operating unit; a complete separation of values would necessarily have to be based on extensive assumptions of unprovable validity; and any attempt at such a separation would in the end serve no purpose except to present an apparent certainty in the formulation of the plan which does not exist in fact. The Act calls for valuations only where necessary and in our view further valuations are not necessary here.

### III

From a practical standpoint a compliance with the decision here in issue will involve administrative difficulties without corresponding benefits. We do not advance the impracticability of complying with the decision as ground *per se* for its reversal. But where as here compliance will spell nothing in terms of accomplishment and will tend to defeat two of the main objectives in the enactment of Section 77, namely, the expediting of the reorganization process and curtailment of expenses (*Continental Bank v. Chicago, R. I. & P. Ry.*, 294 U. S. 648, 685), any interpretation which tends to circumvent these objectives should be viewed doubtfully.

The administrative difficulties are real if not so apparent in the case of the Western Pacific Railroad where the capital structure is comparatively simple. In the case of the larger systems undergoing reorganization, these difficulties will be greatly magnified. In the *Milwaukee Reorganization* there are sixteen classes of system securities outstanding as of December 31, 1938, of which eleven are bond issues having varying liens on different parts of the system.

The decision of the court below requires the Commission in the instant case to evaluate each of the claims of the Reconstruction Finance Corporation, the Railroad Credit Corporation, and other secured creditors including the holders of outstanding mortgage bonds. This would involve a valuation of the security for these claims. The opinion below asserts that there must be a finding of value of the pledged bonds and of the property securing the bonds. If a valuation of the bonds be made upon the basis of the value of the property securing them there arises the impracticability of reaching a separate value on various mortgage divisions operated as a part of a railroad system. If market value of the bonds be used no true value may be reached. A thin market for railroad securities, the presence of distress sales and the fact that the company is undergoing reorganization, leave little weight to the market quotations as a basis for valuing the bonds. Some issues



outstanding may not be listed on the exchange. The values of these bonds if they are to be determined on a market basis would have to be gauged from prices of securities of other railroads by a comparison of yields, earnings coverage, and the separate provisions of the various securities. There would be relatively few securities available for comparison and fewer still which would reflect liens and traffic conditions in any way similar to those of the debtor. A valuation on such a basis would be of little practical help in determining fairness of treatment under a plan of reorganization.

The opinion below asserts that the Commission must find in dollars and cents the value of the new securities which are to be exchanged for the old. Here the difficulties would be accentuated by the lack of information as to the demand on the market for the securities of a railroad just released from bankruptcy with no established credit. Ordinarily there is not even a "when issued" market at the time the plan is approved by the Commission. In the *St. Louis-S. W. Ry. Reorganization, supra*, the Commission said, p. 356:

A reorganization based on expected value of the new securities on the immediate market would necessarily be much more drastic, and result in great and in our view unnecessary, hardship to the junior creditors.

Evidence in support of such values would merely be the expressions of opinion, and the ultimate finding of the Commission even though stated in terms of dollars and cents would be nothing more than informed guesswork.

#### IV

Section 77 was enacted principally as a procedural reform. Expedition and economy were among its chief objects. While rehabilitation of insolvent railroads was possible under equity receivership certain weaknesses, as for instance the use of foreclosure sale and inability to bind non-assenting security holders, as well as lack of control by the court over charges of committees for security holders, also impelled the legislation. Under equity proceedings certain principles had been developed to govern confirmation of plans of reorganization. These principles were not discarded by the enactment of reorganization procedures under the bankruptcy powers. On the contrary, the validity of a plan under Section 77 must be tested by the same principles as have obtained in equity proceedings. Particular reference to these principles has been incorporated in subsection (c) where it is provided that the plan shall "conform to the requirements of the law of the land regarding the participation of the various classes of creditors and stockholders."

The development of these requirements may be briefly recounted.

*Northern Pacific Ry. v. Boyd*, 228 U. S. 482, established the principle that a plan of reorganization was subject to judicial scrutiny as to its fairness. The exclusion of junior claims while permitting old stockholders to participate in the reorganization was condemned. If the value of the road justified the issuance of new stock in exchange for old shares, the creditors could not be foreclosed but were entitled to the benefit of that value, whether it was present or prospective, for dividends or only for purposes of control. Continuing, the opinion states (p. 508):

This conclusion does not, as claimed, require the impossible and make it necessary to pay an unsecured creditor in cash as a condition of stockholders retaining an interest in the reorganized company. His interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock. \* \* \*

Thereafter the courts undertook to pass upon the fairness of plans. Compare *Guaranty Trust Co. v. Missouri Pacific Ry. Co.*, 238 Fed. 812; *Graselli Chemical Co. v. Aetna Explosives Co.*, 252 Fed. 456. But dollar findings of value were not considered as essential in order to adjudge the fairness and equitableness of the plan. This requirement was specifically rejected in the *Guaranty Trust* case, *supra*, the court saying (p. 818):

Complaint is also made that the holders of the bonds on four other branch or subsidiary lines are offered the same or better terms, and comparisons are made between those lines and the Kansas City Northwestern as regards values of the properties and amounts of encumbrance. But there are other considerations than those. The relation of a particular railroad to the system as a whole, its value to the system on that account, and the advisability of including or excluding it, in view of the necessities of the reorganization, enter into the problem. A court cannot well review such matters, but must leave them largely to the business judgment of those in charge. It would, perhaps, be going too far to say a court should never interfere on a complaint of that kind; but clearly it should not do so unless in an exceptional instance of fraud or grossly inequitable discrimination. Generally the objection to a plan of reorganization should involve a definite principle, and not require a long complicated investigation of values, properties, etc. As to this an analogy may be found in the opinion of the Supreme Court on a phase of the Boyd Case.

In dealing with the reorganization of the Missouri-Kansas-Texas Railway this Court, in *Kansas City Ry. v. Central Union Trust Co.*, 271 U. S. 445, passed upon certain questions dealing with the comparative treatment accorded unsecured creditors and stockholders under the proposed

plan of reorganization. In holding upon principles enunciated in the *Boyd* case, *supra*, that a plan will be fair if it tenders to such creditors all that could reasonably be expected under all existing circumstances notwithstanding that it provides for stockholder participation, no suggestion was made that precise dollar findings of value are a prerequisite to a finding of fair treatment.

In *National Surety Co. v. Coriell*, 289 U. S. 426, the Court rejected the plan because the district court had before it only informal, inadequate and conflicting *ex parte* assertions unsupported by testimony. In discussing this deficiency the Court took occasion to say that (p. 436) "A trustworthy appraisal; an account showing the result of recent operations of the business; an accurate determination of the number of creditors, the amounts of their respective claims, and the extent to which collateral given or payments made to them might be deemed preferences; these were facts which might have influenced the court in deciding whether the plan should be approved or should be approved only upon a public sale."

But even here the decision does not assume to state what must comprise the record in order to sustain the fairness of the plan. Concededly there must be adequate and competent evidence upon which the fairness of the plan can be tested and the Court points out the kind and qual-



ity of evidence that will be sufficient for that purpose. But there is no holding that dollars and cents values of the items of property which go to make up the plan, and of the old and new securities, must be ascertained and set out in order to determine whether full compensatory treatment has been accorded.

In *Case v. Los Angeles Lumber Co.*, 308 U. S. 106, a plan of reorganization under Section 77B of the Bankruptcy Act provided for the participation of the old stockholders to the extent of 23 percent of the assets and voting power of the new company in spite of a finding of insolvency by the lower court and a finding that the total of the new stock to be issued would exhaust the total value of all the assets of the debtor. In condemning the plan this Court reiterated and clarified the doctrine of absolute priority and held that the words "fair and equitable" as used in Section 77B were words of art which had acquired a fixed meaning through judicial interpretations in the field of equity receivership reorganizations. But again there is no suggestion in the opinion that the rule of absolute priority must be tested by precise findings of dollar value.

We come then to *Consolidated Rock Products Co. v. Du Bois*, 312 U. S. 510, which the court below has said ruled its opinion. There the plan of reorganization under Section 77B provided for participation of stockholders of the debtor holding company when it did not appear that the un-

mortgaged assets of the subsidiaries had been exhausted, particularly in view of a claim of the subsidiaries under an operating agreement with the debtor. In the present case the court of appeals has seized upon an introductory paragraph in that opinion as laying down a rule that valuations are at all times necessary. It has, however, disregarded the context and the special circumstances involved in the decision. Thus the lower court says (R. 2671):

Lacking the requisite valuation data, the court was in no position to exercise the "informed, independent judgment" which appraisal of the fairness of a plan of reorganization entails.

The court below has interpreted the *Rock Products* decision as requiring the Commission to make sixteen specific dollars and cents findings of value as a condition to approving the plan proposed. But the corresponding paragraph of the *Rock Products* decision reads (p. 520):

On this record no determination of the fairness of any plan of reorganization could be made. Absent the requisite valuation data, the court was in no position to exercise the "informed, independent judgment" (*National Surety Co. v. Coriell*, 289 U. S. 426, 436) which appraisal of the fairness of a plan of reorganization entails. *Case v. Los Angeles Lumber Products Co.*, 308 U. S. 106. And see *First National Bank v. Flershem*, 290 U. S. 504, 525. \* \* \*



The decision then proceeds to consider why in that case no appraisal of fairness could be made. It holds that under the absolute priority rule the bondholders of the subsidiaries were entitled to recourse against the unmortgaged assets of the subsidiaries before the stockholders of the holding debtor company could participate; that there was a claim against the holding company which if valid only to the extent of 25 percent of the book figure would have drawn the entire assets of the debtor down into the estates of the subsidiaries, that thus while the mortgaged assets were found by the district court to be insufficient to pay the mortgage debt, it was also necessary to find the amount of the deficiency and the amount of the unmortgaged assets in order to find that the bondholders would receive full compensation. This Court further held that it was also necessary to determine the fairness of the plan in respect to the subsidiary bondholders *inter sese* because the plan treated them equally while claim was made that the value of the assets of one subsidiary was greater than that of the other. In this connection the opinion states there should be "some appropriate formula for at least an approximate ascertainment of their respective assets."

We submit that this Court did not lay down any rule of exact-determination in terms of dollars and cents of the values of the various items treated in formulating a plan of reorganization

in order to test its fairness. Indeed the opinion recognizes that the rule of full compensation is flexible and will yield to the practicalities of the case (pp. 529-530):

Practical adjustments, rather than rigid formula, are necessary. The method of effecting full compensation for senior claimants will vary from case to case. As indicated in the *Boyd* case (228 U. S. at p. 508) the creditors are entitled to have the full value of the property, whether "present or prospective, for dividends or only for purposes of control," first appropriated to payment of their claims. But whether in case of a solvent company the creditors should be made whole for the change in or loss of their seniority by an increased participation in assets, in earnings or in control, or in any combination thereof, will be dependent on the facts and requirements of each case. So long as the new securities offered are of a value equal to the creditors' claims, the appropriateness of the formula employed rests in the informed discretion of the court.

The decision of the court below in the instant case attempts to measure the adequacy of the Commission's treatment of the various claims upon the form in which its findings and conclusion were stated. In so doing it reads into the *Rock Products* case a rule that was not enunciated or intended. The inadequacy of the findings in the *Rock Products* case did not derive from the form which they

took but from a deficiency in the record. The decision declares that earning power is the dominant measure of present worth for reorganization purposes and any estimate of future earnings "must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth"; and "since its application requires a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made."

The Commission's report gave dominant weight to earning power in determining total allowable capitalization and the allocation of the new securities. It had before it extensive studies of the Debtor's traffic and revenues and earnings as a whole and broken down, insofar as was possible, with respect to the several divisions of the system. The Commission's analysis of this and other elements of value supported its findings as to the fairness of the exchanges of securities provided by the plan. Its conclusions were expressed in terms of the new capital structure; it did not assume to ascribe absolute dollar values in order to give the appearance of certainty.

What the Commission has done is to provide a plan of reorganization which fully complies with the rule of full compensatory treatment based upon its opinion as to what allocation of new securities will constitute equitable treatment for the surrender of the entire "bundle of rights." This, we submit, is all that Section 77 and the decisions of this Court require.

## CONCLUSION

The Commission's interest in this case lies primarily in working out a definite, well-understood procedure which will admit of prompt and efficacious railroad reorganizations. The procedure required by the decision of the Circuit Court of Appeals does not subserve this end. If the rights of all parties to the proceedings are protected, if their treatment in the plan of reorganization provides substantial justice having due regard to judicial determination of the nature and extent and the relation of such rights to those of other parties in interest, all of which has been provided in a plan based upon substantial evidence, no obeisance should be made to form at the sacrifice of what otherwise is a "fair and equitable" plan.

The judgment of the Circuit Court of Appeals should be reversed and the cause remanded with directions to affirm the order of the District Court approving the plan of reorganization.

Respectfully submitted.

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